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Business trusts

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and to apply scientific principles to the practice of the art. But, by and large, it is every man for himself, guided by his self-interest, his knowledge of his subject, with results determined by his calibre, his resourcefulness, and his luck.

Is it not time for the accountant, if he hopes for success, to learn a lesson from the signs all about him; to reach an agreement

with other accountants as to what the profession is undertaking to do; to classify, define, and differentiate the service which he is rendering? Can the public expect any less in a country where the service of railroads, Pullmans, porters, dining-cars, taxis, hotels, waiters, bell-boys, bootblacks, hat cleaners, and scrub women has been standardized?

Business Trusts

ONE of the notable developments of all industrial history is that of the business corporation. This form of business organization now dominates industry the world over. The rapidity and magnitude of its growth is remarkable in view of the fact that the use of the corporate form of organization in the conduct of business is confined almost entirely to the last hundred years. The corporation has been an important factor, both economically and socially, in the progress of our country, chiefly through the development of vast resources.

The principal advantages of the corporation as compared with other forms of organization are the following: (1) limited liability of stockholders; (2) transferability of shares; (3) continuity; (4) ease in obtaining capital. Perhaps the most important of these advantages is that of limited liability. Without this protection to stockholders, sufficient capital to conduct the volume of business which is now being carried on by corporations probably could not be obtained. The chief characteristic upon which the several advantages hinge is the fact that the corporation is a separate entity—a creature of the state.

Notwithstanding its advantages, there is a growing dissatisfaction among business men with the corporate form of organization. Apparently the fundamental characteristic which has given such value to the corporation—the fact that it is an artificial entity distinct from the persons composing it—is being utilized as the basis for im-

pairing its usefulness. Since the corporation owes its existence to the state, legislatures have made greater demands of business organizations conducted as corporations than of those operating under any other form of organization. The exactions which have been imposed by way of taxation, investigation, reports, and so forth, indicate that the legislative attitude toward corporations is not entirely constructive. Add to this the difficulties in complying with the different laws of the several states which are becoming more burdensome with the constantly changing legislation, and it is only natural that business men should be seeking another device which will secure the advantages of a corporation and yet not be subject to irritating legislation.

Any agency designed to take the place of the corporation must have as its essential characteristic the limited liability of the investor. Unless it is possible for men to contribute to a business enterprise without thereby endangering their entire private fortunes, it is useless to attempt to raise capital in amounts sufficient to transact any considerable part of the business of the country. The co-partnership and joint-stock company, therefore, are eliminated from consideration.

The business trust has been suggested as a possible substitute for the corporation, not as a panacea, but as a satisfactory method of carrying on business under certain conditions. This type of organization is known also as an "express trust," "trust

estate," and "common law trust." It is created by the execution of a declaration of trust which contains all the provisions necessary for the proper operation of the trust. Equitable interest in the property is vested in the beneficiaries or shareholders, who correspond to the stockholders in a corporation. Legal title is vested in the trustees who occupy a position similar to a board of directors. The trust fund corresponds to the capital of the incorporated company and the beneficial interests or shares to the corporation's shares of stock.

The eminent English jurist Maitland has said, "Of all the exploits of equity the largest and most important is the invention and development of the trust. It is an institute of great elasticity and generality; as elastic, as general as contract." Because of its comparatively recent evolution, the law of trusts has developed more systematically and more symmetrically than the older branches of law. The business organization operating under a trust agreement is able to conduct its affairs in any state as freely as an individual or co-partnership upon the common law right of contract, without being subject to the statutory exactions that are imposed upon corporations. The trustees are "citizens" within the meaning of the constitution, and hence they are entitled to all the privileges of citizens, and may transact business in any state upon equal terms with every other citizen.

With the advent of the business trust, the corporation is no longer the exclusive agency for the employment of the combined capital of numerous investors. In order to secure limited liability to the beneficiaries, however, it is necessary that absolute power be given to the trustees in the management of the property. The only safe course to pursue in drawing up a trust agreement is to refrain from reserving any rights to the shareholders beyond those which the law attaches to beneficiaries of a trust. If the shareholders manage the business in any way, such as to elect

trustees annually, to initiate amendments to the trust agreement, or to give directions to the trustees, they will make themselves liable as partners.

Under the common law the trustee bound himself personally when he contracted as trustee. However, the Supreme Court laid down the general rule that a trustee may protect himself from liability on a contract by expressly stipulating that he is not to be responsible personally, but that the other party is to look solely to the trust estate. In the absence of this protection, it would be difficult to find trustees who would be willing to undertake the responsibilities of carrying on trade for others. The trust indenture, therefore, should provide that trustees are not to be liable personally, and that creditors are to look exclusively to the trust fund. Generally all stationery and documents used by the firm have such provisions printed upon them to give notice to those dealing with the trust. Nevertheless, creditors have a right against the trustees individually in case of fraud or negligence.

One of the advantages of a business trust is that the trustees have a general right to apply to the courts of equity for direction in the execution of their powers. In this way their acts are given legal certainty in advance of their execution. A corporation has no similar right to ascertain in advance the legality of its intended acts. It is necessary to commit the act first and then have the construction of the statute determined by means of test cases. However, in case the trustees have not gone to court for advice, they may not have their acts ratified by the court after such acts have been performed. The trustees have no right to seek the direction of the courts unless there is some doubt or conflict of opinion as to the proper interpretation of the trust instrument with respect to the rights and powers of the trustees.

The business trust also has a distinct advantage over corporations in regard to taxes. The corporation must pay an

organization tax, a property tax, a franchise tax, a capital stock tax, and an income tax; in fact, the bulk of our present day governmental revenues is obtained indirectly from the public through the several corporate taxes. In addition, shareholders frequently must pay a personal tax on the shares which they own. With the trust organization, however, double taxation is avoided, for the legal interest and the equitable interest in the same property cannot both be taxed. Either the trustee or the beneficiary (but not both) pays the tax on the trust property. If the trustee and beneficiary reside in different states, the tax is imposed where the property is held. In the only case in which a trust instrument of this type of organization has been tested by the Supreme Court (*Crocker v. Malley*, 1919), it was held that the express trust in question was a pure trust and should be taxed under the provisions of the income tax act of 1913 relating to fiduciaries. Under the present revenue act, the distributable income is taxable to the beneficiaries. Although a business trust is exempt from paying a franchise tax, capital stock tax, or excise tax, in some states the beneficial shares are subject to a stock transfer tax. The law is not uniform for all states with respect to taxation, but, in general, the trust estate has a more favorable tax status than the corporation.

With respect to length of life the advantage seems to be with the corporation. The duration of a trust may be for any period not to exceed the provisions against perpetuities. The duration may vary in the different states from twenty-one years from date of creation to twenty-one years after the death of the last beneficiary who was a beneficiary when the trust was created. A trust may be dissolved by agreement as readily as a corporation.

There are other handicaps to the successful use of express trusts in business on any extensive scale. The employment of the trust device for the formation of organizations which have operated in restraint of

trade has brought about a popular prejudice against any organization carrying the name "trust." Moreover, the business trust has been brought further into disrepute through its use by incompetent persons for exploitation of one kind or another. Before there will be any considerable diversification of ownership of beneficial shares in a trust, it will be necessary to acquaint the public with the characteristics of a business trust and its securities. In the meantime the familiarity of the investing public with corporate securities will give corporations an advantage over trusts in marketing their respective shares.

The courts did not object to trusts as a form of organization, but to the use of trusts for illegal purposes. A trust form of organization may be employed for any legitimate purpose. However, a business trust is more adaptable to some industries than to others. It is not suitable for those activities which are subject to state regulation and control, such as public utilities, banking, and insurance. It cannot be used where entire ownership and control rest in one individual, as in those corporations with one principal and two dummy stockholders.

The business trust is appropriate where it is desirable to have permanency of management. It has been used with entire satisfaction in Massachusetts in the business of dealing in real property. It is an ideal form of organization for those companies specializing in owning or dealing in the securities of other companies, such as holding companies and investment companies. The business trust may be used also for a concern conducting an apartment building or a hotel, or developing a subdivision, or for any other business with operations of a routine character.

The status of the trust form of business organization is as yet rather uncertain. The two states which created special legislation, Massachusetts and Oklahoma, have exhibited a favorable attitude toward business trusts. The increasing popularity of

trusts probably will cause other states to pass laws concerning the operations of trusts engaged in business. The position of the trust in business then will be defined more satisfactorily as the attitude of the states and courts is revealed through legislation and decisions. The uncertainty of status makes it all the more advisable that the assistance of a competent legal adviser be sought in drafting the trust agreement.

The business trust is likely to take a more important place in the industrial world each

year. In principle it should serve adequately the needs of business men in certain fields of industry. Care should be taken to guard against the use of the business trust to shield operations of a questionable character or to evade responsibilities. The trust form of business organization should not be considered as a possible exterminator of the corporation, but should be looked upon as a serviceable expedient to supplement the corporate form of organization in industry.

Insurance on the Lives of Executives

(Concluded)

IN a previous article on this subject the point was made that it is fairly common for a business concern to carry insurance on the lives of its principal executives, especially when the conditions are such that the business would suffer materially from the death of any one of them. Before discussing the accounting and auditing phases of the subject, which is the purpose of this article, two further facts should be brought out, namely, that policies representing such insurance have an investment value and, with the exception of term insurance, also have a cash surrender value. The latter feature, however, usually does not become operative until the policy has been in force for two years.

When the life of an individual is insured in favor of a business concern, the premiums on such insurance paid by the concern may be regarded as advance payments to provide resources with which to indemnify the business for anticipated losses in the event of the death of the individual or to discharge obligations which are expected to arise at that time. The method of handling these payments in the accounts depends to some extent upon the purpose for which the insurance is carried. Frequently, however, the treatment is dependent rather upon the policy of the management with respect to conservatism.

The procedure generally advocated is to consider the cash surrender value of each policy as an asset. Each premium after the second year is divided, a part being debited to the asset account, and the remainder being charged against income. The former share increases and the latter decreases from year to year.

Since insurance is taken essentially to provide for future losses, this plan is open to criticism in that the margin between the face of the policies and the value at which they are carried is reduced each year, thereby lessening the only effective protection against such losses. If the purpose for which the insurance was purchased no longer exists and the policies would be canceled if it were not for their accumulated value, the foregoing procedure might be put into operation without objection.

Assuming that the individual will continue to be identified actively with the business until his death, and that it will be thought desirable to keep the policies in force, the amount of the insurance almost certainly will exceed the premiums paid, and therefore it might seem proper to capitalize all the premiums paid. However, if the object in carrying the insurance is to furnish protection against anticipated losses upon the death of the insured, it is necessary to provide a reserve out of the present profits against which such losses